



The Third Dimension

An Investor's Guide to Understanding the Impact of "Quality" on Portfolio Performance

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Executive Summary

- Most investment managers are categorized along two dimensions: market capitalization and investment style. However, there is a third dimension – quality, which can significantly influence a portfolio's risk and return characteristics as well as distort, if not overwhelm, the influences of size and style.
- Fluctuations in the performance between high and low quality stocks are not random or totally unpredictable events. In fact, a "quality cycle" appears to exist which is closely related to the economic and stock market cycle.
- For the 30 years ending 2009, high quality stocks have outperformed large and small cap, and growth and value stocks with substantially less volatility. Contrary to efficient market theory, superior risk-adjusted returns are available to high quality investors.
- An investment manager may have hidden quality biases. So called "conservative growth" and "relative value" managers often have a high quality bias. "Absolute value" and "aggressive growth" managers often have a low quality bias.
- Low quality stocks dramatically outperformed high quality issues during 2009. With several indicators pointing to a potential leadership change in favor of high quality, investors may be well served to examine the quality composition of their aggregate portfolio to ensure that they maintain an appropriate level of diversification to high quality ranking stocks.

Measuring the Impact of Size, Style & Quality on Total Return

For many years, investors have diversified their equity portfolios by both market capitalization and investment style, or according to the popular nine-square style box. The basis of this approach is the theory that large and small cap, and growth and value stocks explain most of the variation in equity returns and, although individually risky, dampen risk when aggregated within a portfolio. However, our research indicates that it is imprudent to ignore quality and invest solely by capitalization and style dimensions. In fact, the performance of high and low quality stocks can have a significant influence on an investor's risk and return characteristics, in many cases overwhelming the influence of either size or style.

In general, most investors deem high quality stocks to be those with steady, consistent earnings growth, modest debt to equity ratios, and above average returns on invested capital. It's not surprising that companies with these financial characteristics typically have seasoned management teams and strong competitive positions in their key markets. Low quality stocks, on the other hand, are those with erratic or highly cyclical

earnings, heavy debt burdens, and poor returns on capital. Typically these companies have less experienced managers, less dominant market positions, and are, on average, smaller in size and have shorter track records as public companies.

The Standard and Poor's Earnings and Dividend Rankings score the financial quality of several thousand US stocks from A+ through D with data going back to 1956. The company rankings are based on the most recent 10 years (40 quarters) of earnings and dividend data. The better the growth and stability of earnings and dividends, the higher the ranking.

We believe that the S&P Quality Rankings provide investors a useful time series for measuring trends in the performance of high and low quality stocks. The rankings are not infallible, but they are unbiased, empirical and have been calculated the same way for a lengthy period of time. Atlanta Capital uses these rankings along with several other proprietary and non-proprietary analytical tools to evaluate the financial quality of companies in which we invest.

For the purpose of this study, we have constructed a custom set of quality indexes. The universe includes all Russell 3000 Index constituents with S&P Quality Rankings and prices greater than \$1. The Russell High and Low Quality Indexes are provided to compare the performance of stocks with above average S&P Quality Rankings (B+ or Better) to those with below average S&P Quality Rankings (B or Below, and Not Rated). Each index is formed and rebalanced monthly, and returns are calculated using a market capitalization-weighted methodology. At year-end 2009, approximately 60% of the market capitalization of the Russell 3000 Index was ranked “B+ or Better” and 40% ranked “B or Below” and “Not Rated.”

In addition to our pair of custom quality indexes, the Russell Indexes are used as reliable proxies for market capitalization and style categories. These indexes are also utilized to depict how most investors structure their US equity manager line-up. The Russell 1000 and Russell 2000 Indexes measure the

performance of stocks with large and small market capitalizations, while the Russell 1000 Growth and Value Indexes measure the performance of the growth and value investment styles. The Russell 3000 Index measures the performance of a broadly diversified portfolio of US common stocks.

Table 1 depicts the 2009 calendar year return of our size, style and quality indexes in comparison to the Russell 3000 Index. As indicated, low quality stocks outperformed the broad market by 17.3% in 2009. This was substantially greater than the 8.9% premium generated by growth stocks and the mere 0.1% premium generated by large cap stocks. Clearly, each size, style and quality index responded differently to the same economic stimuli applied throughout the year. Knowledge of this differential behavior can help investors manage the volatility of their equity portfolios and, ultimately, enhance their total rate of return.

Table 1. 2009 Returns By Size, Style and Quality

	Russell 3000	Size		Style		Quality	
		Russell 1000	Russell 2000	Russell 1000 Growth	Russell 1000 Value	Russell High Quality	Russell Low Quality
Total Return of Index	28.3%	28.4%	27.2%	37.2%	19.7%	18.8%	45.1%
Premium / Deficit vs. R3000	---	0.1%	(1.1%)	8.9%	(8.6%)	(9.4%)	17.3%

The “Quality Cycle” is Closely Related to the Economic and Stock Market Cycle

Our research indicates that the amount of exposure to high and low quality stocks can have just as meaningful of an impact on return as an investor’s exposure to large and small cap, and growth and value stocks. In addition, fluctuations in the performance between high and low quality stocks are not random or totally unpredictable events. In fact, a “quality cycle” appears to exist which is closely related to the economic and stock market cycle.

Figure 1 shows for the last 30 years, the annual difference in return between each pair of our size, style and quality indexes. From this analysis, we can observe that the magnitude and frequency of the quality differential is comparable to that of size and style. For example, quality is the single largest contributor to performance in 10 of the 30 periods or in 33% of the observations.

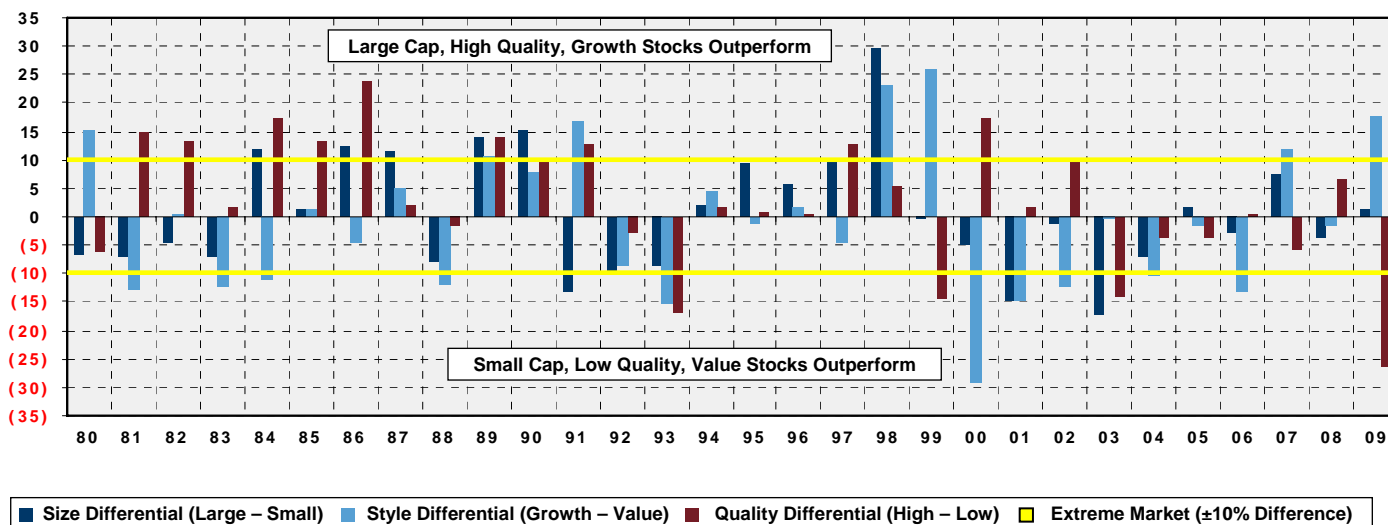
Secondly, there are only six periods when low quality stocks outperform high quality by 500 basis points or more — 1980, 1993, 1999, 2003, 2007 and 2009. In the other 24 periods or 80% of the observations, high quality dominates low quality or lags it by only a modest amount. To see if any important

patterns emerge, Table 2 examines the economic and capital market conditions that existed during each of the six years when low quality dominates.

From this data we can conclude that the dominance of low quality stock performance over high quality tends to occur at the beginning and the end of a stock market cycle. Low quality outperformance during the middle of an economic or stock market cycle is rare. These occurrences are not random in our view. The relatively brief spurts of low quality outperformance make intuitive sense when analyzed in the context of the economic, monetary and stock market conditions.

By their nature, low quality stocks are usually more economically sensitive than high quality stocks. In addition, they tend to be more reliant on the debt markets, because they are usually more capital intensive and less able to finance growth through internal resources. When the economy slides into recession following a period of monetary tightening, low quality stocks tend to fall further than high quality issues because low quality company profits are more vulnerable to deteriorating economic and credit market conditions.

**Figure 1. Periods of Extreme Market Performance
Size, Style & Quality Differentials**



Typically, once Washington becomes sufficiently concerned about recession, the Federal Reserve aggressively eases credit market conditions and Congress and the President cut taxes and raise spending in an effort to turn the economy around. Low quality stocks, which tend to fall the most during a bear market, tend to lead the initial phases of a new bull market because these bear market laggards have the most to gain from improving credit market and economic conditions.

Why do low quality stocks also tend to outperform high quality at the end of a bull market? After all, economic and credit market conditions are much different at the beginning of a stock market cycle than at the end. We think the primary reason that low quality stocks outperform as the market nears

a cyclical peak is that investor speculation is often widespread near stock market tops. In the late stage of a bull market, stock prices have been rising for a sustained period of time, luring more and more unsophisticated investors into the market. In the latter stages of a bull market a widely recognized market leader has developed—for example, oil stocks in the late 1970s, consumer growth stocks in the 1980s, internet stocks in the late 1990s, and energy and housing stocks in the last decade. As more and more investors chase the same investment theme, they become less quality conscious and buy stocks of secondary companies and / or new issues with inexperienced management teams. As a result, low quality stocks outperform the broad market, right up until it peaks and turns down.

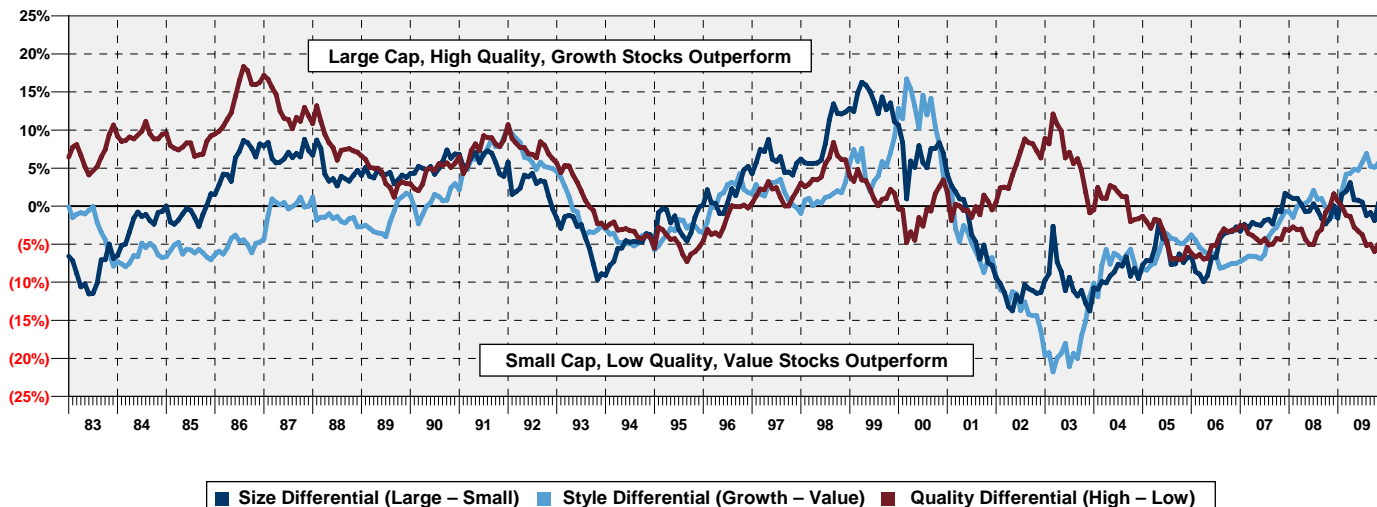
Table 2. Environmental Conditions During Strong “Low Quality” Years

	Economic Conditions	Monetary Conditions	The Stock Market
1980	Brief recession in 1980, followed by a second in 1981-82.	Fed tightened early in 1980, then eased.	Last year of 1975-80 bull market led by energy.
1993	Long expansion between recessions of 1990-91 and 2001.	Fed easing since 1990, followed by abrupt tightening in 1994.	Near beginning of 1991-99 bull market led by technology.
1999	Strong US economy led by technology spending, slows in 2000 with dot.com bust, recession begins in 2001.	Fed eased in mid-1998 in response to emerging market debt crisis and Long-Term Capital Management rescue, then tightened in late 1999.	Last year of 1991-99 bull market led by technology.
2003	Synchronized global economic expansion from 2002-07.	Fed easing.	First year of 2003-07 bull market led by energy, metals & mining, and housing related stocks.
2007	US growth slowing, real estate deteriorating rapidly.	Fed tightening, yield curve flat.	Last year of 2003-07 bull market.
2009	Severe recession in 2008, signs of recovery 2009.	Fed easing since subprime crisis of 2007.	First year of 2009-? bull market.

Figure 2 depicts the rolling 36-month annualized performance differentials between each pair of our size, style and quality indexes. As illustrated, the variation in each performance

differential ebbs and flows over time and does not appear to be random. A cyclical performance pattern clearly exists between each pair of our size, style and quality indexes.

**Figure 2. Rolling 36-Month Excess Returns
Size, Style & Quality Differentials**



What's the Outlook for High Quality Stocks in 2010 and Beyond?

We expect high quality stocks to post stronger relative returns in 2010 and 2011 following their lackluster showing versus low quality during 2009. The drivers of this expected outperformance should be 1) attractive valuations relative to low quality issues, 2) a less stimulative fiscal and monetary policy environment, and 3) a likely moderation in the pace of earnings growth and investors' appetite for risk.

What was unusual about 2009 was the extremely large gap between high quality and low quality performance. Low quality stocks outperformed high quality by 26.7% in 2009. This was wider than the 17.5% gap in favor of growth over value and the 1.2% gap in favor of large cap over small cap.

In retrospect, 2009 was a fairly typical period for strong performance by low quality stocks. The economy was in its second year of recession and government was aggressively applying fiscal and monetary stimulus to lift the economy out of the abyss. Credit spreads in the bond market began to narrow early in the year as investors' appetite for risk slowly returned. Equities, sensing that an economic recovery was three to nine months away, began to rise in March. After sharply underperforming high quality during 2008, low quality stocks sprang back to life.

The strong relative performance of low quality in 2009 completely erased the valuation premium which is normally accorded to high quality issues. Table 3 shows recent valuation and financial metrics for high quality and low quality non-financial stocks in the Russell 1000 Index. (We exclude the financials because the huge write offs and losses in this sector can distort the data.) Each quality sample contains about 320 equally-weighted names.

From the table, note that high quality stocks sell at a price/earnings discount to low quality issues while providing a higher dividend yield.

Table 3. Russell 1000 Index as of February 26, 2010

	Price / Earnings 2010	Dividend Yield	Debt to Capital	Return on Equity	Earnings Stability (20 Quarter R ²)
Russell High Quality	17.1x	1.8%	31%	19.1%	0.60
Russell Low Quality	20.1x	1.1%	34%	14.2%	0.48

The poor relative showing of high quality stocks in 2009 coupled with their relative low valuations is one key reason that high quality issues may outperform low quality during 2010.

Another important reason is that monetary and fiscal conditions are likely to become less stimulative in 2010. Several major countries -- namely China and Australia -- have already begun to tighten monetary policy as inflation pressures emerge in East Asia and in the natural resource based economies. In the US, the Federal Reserve is expected to begin a "less accommodative" monetary policy around mid year. Tax rates on income, dividends and capital gains are likely to rise in 2011 with the expiration of the Bush tax cuts

and new tax proposals to finance health care reform. A more restrictive monetary and fiscal policy generally favors high quality companies which are less leveraged and less dependant on the credit markets.

The third reason that high quality stocks may post stronger relative performance in the months ahead is that the sharp reacceleration in earnings and economic growth in 2010 should start to dissipate in 2011 as the economic recovery matures. In an environment of tighter monetary conditions, higher taxes and slower economic growth, investors typically become more risk averse and favor high over low quality stocks.

Is the Performance of High & Low Quality Stocks Correlated with Size & Style?

Correlation is one of the most commonly used tools to test the benefits of diversification. Specifically, correlation measures the degree to which two variables are associated, and is bound by a range from +1.0 to -1.0. A positive correlation indicates that the two variables move, to a degree, in the same direction, and a negative correlation implies that the variables move, to a degree, in the opposite direction. A correlation close to zero signifies that the relationship between the variables is random or uncorrelated.

Often, correlation of excess returns (as opposed to nominal returns) is used when constructing a diversified portfolio within the same asset class. Correlation of excess returns is simply the correlation of one portfolio's return in excess of a benchmark to another portfolio's return in excess of the same benchmark. By factoring out the benchmark return and focusing on excess returns, we can test whether different portfolios outperform a broad market index at approximately the same time.

To estimate the relationship between all possible pairs of our size, style and quality indexes, we have 15 unique correlations to estimate. Table 4 has arranged these correlation coefficients in a correlation matrix. To locate the correlation coefficient between any pair of indexes, find the number in the matrix that intersects the row and column for those two indexes. For instance, the correlation of excess returns between the Russell 2000 Index and Russell 1000 Index is -0.98. A correlation of -0.98 implies that small cap stocks *outperform* the Russell 3000 Index at about the same time that large cap stocks *underperform*.

The correlations calculated in Table 4 can help us understand the relationships between all possible pairs of our size, style and quality indexes. Key observations indicate that not only does an inverse relationship exist between the return behavior of high and low quality stocks, but diversification benefits exist

Table 4. Correlation of Excess Returns For 30 Years Ended December 31, 2009 Relative to the Russell 3000 Index

Russell 1000	1.00					
Russell 2000	(0.98)	1.00				
Russell 1000 Growth	0.20	(0.22)	1.00			
Russell 1000 Value	0.08	(0.05)	(0.96)	1.00		
Russell High Quality	0.43	(0.41)	(0.31)	0.44	1.00	
Russell Low Quality	(0.38)	0.38	0.12	(0.24)	(0.88)	1.00

when our pair of quality indexes are combined with our size and style indexes.

Our initial observation suggests that high quality stocks tend to *outperform* the Russell 3000 Index at about the same time that low quality stocks *underperform*. The near-perfect negative correlation between high and low quality stocks (-0.88) is similar to the negative correlations that exist between large and small cap stocks (-0.98), and growth and value stocks (-0.96). A correlation of -0.88 implies that the excess return between each quality portfolio and the Russell 3000 Index tends to move in the opposite direction of the other about 88% of the time.

Of course, correlations do not always remain stable and can

change over time. To examine the consistency of the historical relationship between high and low quality stocks, Figure 3 plots the rolling 12-month excess return of each quality index relative to the Russell 3000 Index. Notice the performance patterns appear to be a mirror image of each other, meaning the portfolios consistently move in opposite directions. A similar performance pattern would be apparent if we plotted the historical excess returns of each pair of our size and style indexes relative to the same index. This inverse relationship explains why most investors continue to diversify their equity portfolios by market capitalization and investment style.

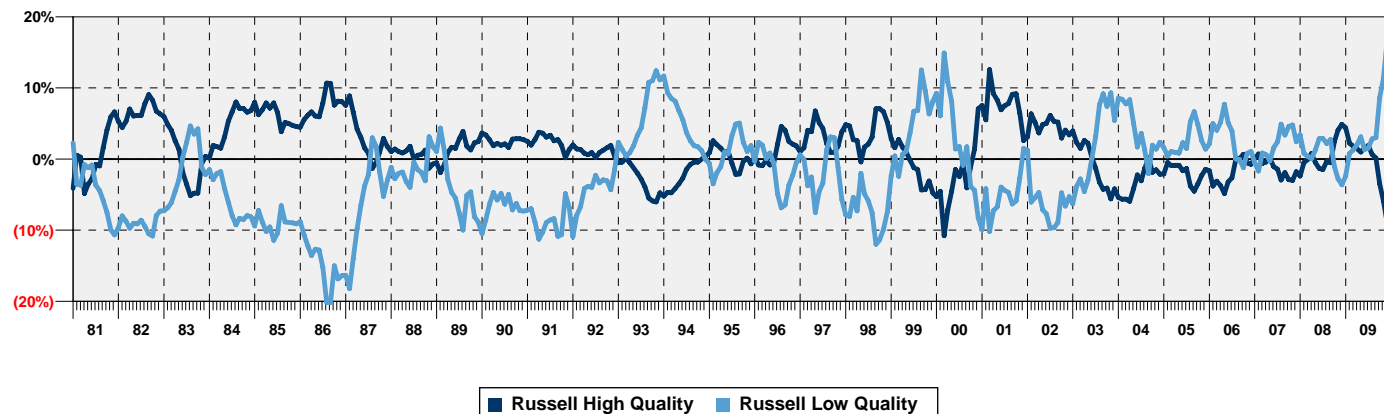
Another key observation is that our size, style and quality indexes exhibit weak correlates relative to each other. Each index appears to outperform the Russell 3000 Index at different points in time. For reference, a correlation greater than 0.8 is generally described as *strong*, whereas a correlation less than 0.5 is generally described as *weak*. Although high quality stocks appear positively correlated to

both large cap (+0.43) and value stocks (+0.44), they are considered weak relationships.

While correlations are reported as a value between -1.0 and +1.0, squaring them makes them easier to understand. The square of the correlation coefficient (or r-square) indicates the extent to which the variability of a portfolio's return is explained by the variability of another portfolio's return. For example, the square of the correlation coefficient between high quality stocks in comparison to large cap stocks is 0.18 (0.43 x 0.43). An r-squared value of 0.18 indicates that only 18% of the fluctuation in the high quality portfolio's excess return is explained by the fluctuation in large cap stocks.

As a result, the returns derived by investing in our pair of quality indexes appear to be influenced by factors other than size and style. We believe that quality, as a third dimension of portfolio classification, provides diversification benefits when combined with the two traditional dimensions of size and style.

Figure 3. Rolling 12-Month Excess Returns vs. Russell 3000 Index



Which Portfolio Offers the Greatest Potential to Enhance Total Return?

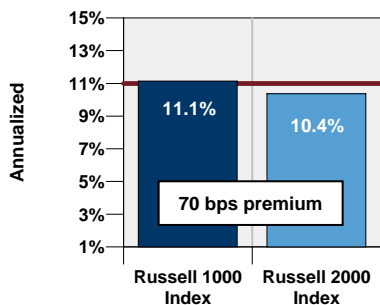
Our research demonstrates that, on average, high quality stocks outperform low quality stocks as well as the market as a whole. In addition, investing in high quality stocks offers the greatest potential to enhance an equity portfolio's total return in comparison to size and style-based investing. A fundamental advantage appears to exist to high quality investors.

Since 1980, the Russell 3000 Index has generated a compound annual return of 11.0%. Over the same period, the Russell High Quality Index has delivered a 12.4% compound annual return or a 140 basis point annualized premium relative to the broad market index. Our pair of size and style indexes have experienced much less favorable results, yet continue to serve as the basis for many US equity manager structures.

One of the many myths of investing is that over time stocks with small market capitalizations outperform stocks with large market capitalizations. Capital market theory would suggest that this must be true because small cap stocks are riskier investments and investors must be compensated for bearing this risk by a risk premium. But, as Figure 4 illustrates, over the last three decades large cap stocks have outperformed small cap stocks by 70 basis points per year. In comparison to the Russell 3000 Index, large cap stocks have generated a 10 basis point annualized premium. Evidence suggests that over the last 30 years, investing in large cap stocks has resulted in a slight advantage for investors.

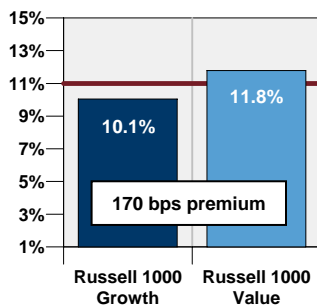
The foundation of value investing is well known and has been

Figure 4.
Size Index Returns
(1980 - 2009)



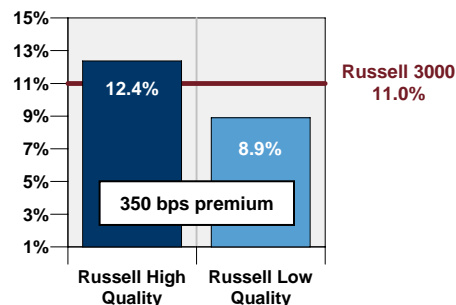
Ranked by
Market Capitalization

Figure 5.
Style Index Returns
(1980 - 2009)



Ranked by
Price-to-Book and
Forecasted Earnings Growth

Figure 6.
Quality Index Returns
(1980 - 2009)



Ranked by
Stability of Historical
Earnings Growth

embraced by investors ever since Ben Graham and David Dodd began teaching at Columbia Business School in 1928. Historical analysis of portfolios formed by grouping stocks together by low price-to-book ratios as opposed to high forecasted earnings growth rates has revealed that higher returns are available to those investors who hold portfolios of undervalued stocks. The historical performance of our style benchmarks confirm that, on average, value stocks outperform growth stocks, as well as the market as a whole. Figure 5 demonstrates that over the last 30 years, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by 170 basis points per year. Over the same period, the value style has generated an 80 basis point annualized premium relative to the broad market index. Clearly, value investing has proven to be a successful investment strategy.

Our research indicates that grouping stocks by the stability of historical earnings growth offers a similar, if not a superior, long-term advantage in comparison to value investing. For

example, Figure 6 shows that over the last 30 years, high quality stocks have outperformed low quality stocks by 350 basis points per year, nearly double the value advantage! The 12.4% compound annual return generated by the Russell High Quality Index also represents the highest absolute return in comparison to the other size, style and quality indexes. Given the performance advantage inherent in high quality stocks, it stands to reason that a strategic allocation to “high quality” could enhance an equity portfolio’s total return.

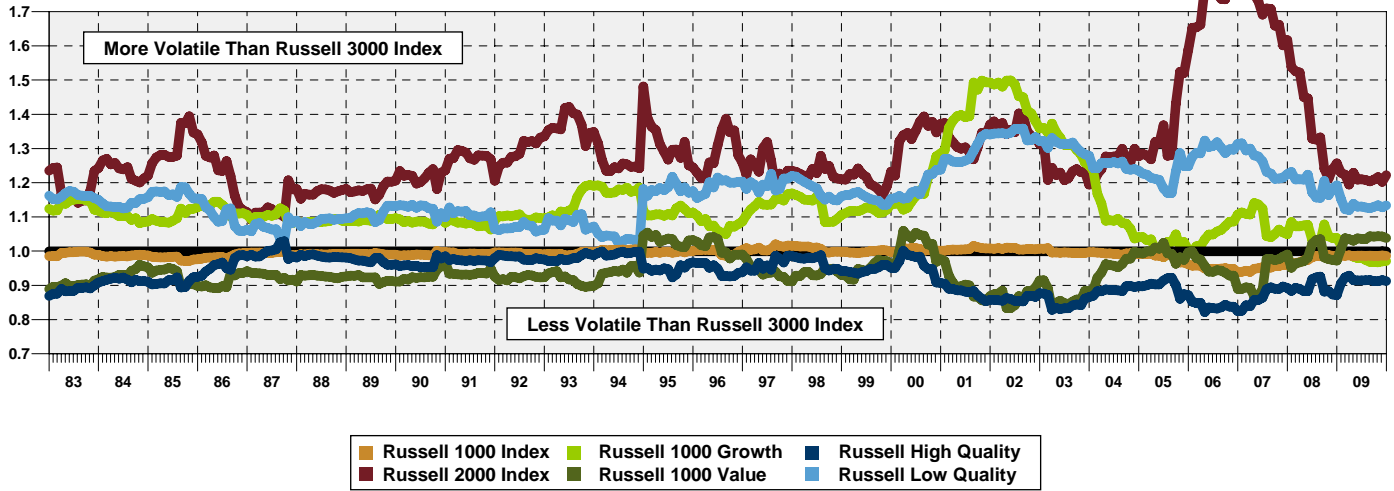
While the performance advantage of high quality stocks appears to hold over the long-term, deviations are certainly possible in the short-term. As referenced in Table 4, a strategy of holding low quality stocks over the last five years would have produced significantly superior returns to a strategy of holding high quality stocks. Historically, mean reversion has forced these relationships back into equilibrium and in line with their long-term averages. Therefore, a substantial rebound in favor of high quality stocks may be near.

Table 4. Compound Annual Returns
Periods Ended December 31, 2009

Index	5 Years	10 Years	20 Years	30 Years
Russell 3000 Index	0.8%	(0.2%)	8.4%	11.0%
Russell 1000 Index	0.8	(0.5)	8.4	11.1
Russell 2000 Index	0.5	3.5	8.3	10.4
Russell 1000 Growth	1.6	(4.0)	7.5	10.1
Russell 1000 Value	(0.3)	2.5	8.8	11.8
Russell High Quality	(0.2)	0.3	8.8	12.4
Russell Low Quality	3.5	0.1	8.2	8.9

Superior Risk-Adjusted Returns are Available to "High Quality" Investors

Figure 7. Volatility of Returns Relative to Russell 3000 Index
Rolling 36-Month Annualized Standard Deviation



When comparing investments, investors should always evaluate how much an investment returned in relation to the amount of risk undertaken. Adjusting a *high return* because an investor was rewarded for taking on *more risk* simply "levels the playing field" for comparison. In the end, risk-adjusted returns help investors identify which investments were the most efficient or offered the highest incremental return per unit of risk taken.

Risk can be measured in several ways, but the most common measure is the standard deviation of return. Standard deviation measures the extent to which actual returns vary over time from the historical average. A higher standard deviation indicates higher risk or volatility, whereas a lower standard deviation implies lower risk or greater consistency in return.

Often, relative standard deviation is used to compare the variability of returns across asset or sub-asset classes. It measures the volatility of one portfolio's return as a percentage of the volatility of another portfolio's return. For example, Figure 7 plots the rolling 36-month annualized standard deviation of our size, style and quality indexes relative to the Russell 3000 Index. Over time, it appears that small cap, low quality, and growth stocks are riskier propositions in comparison to the broad market. This implies that investors should receive higher returns from these more volatile stocks as compensation for bearing more risk. However, the exact opposite has occurred. In fact, although large cap, high quality, and value stocks have demonstrated the least amount of risk (volatility), they have delivered the highest absolute rates of return.

Figure 8. Reward to Risk Tradeoffs
Last 30 Yrs Ending 12/31/09

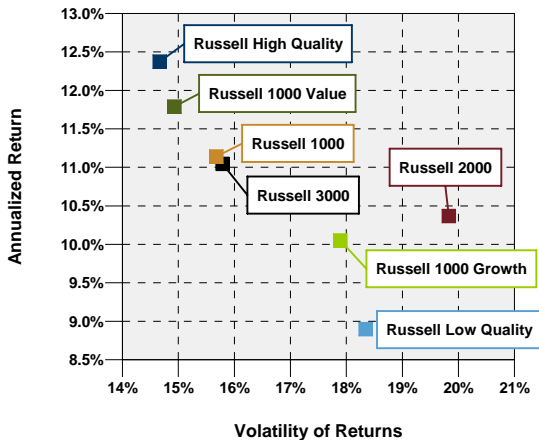
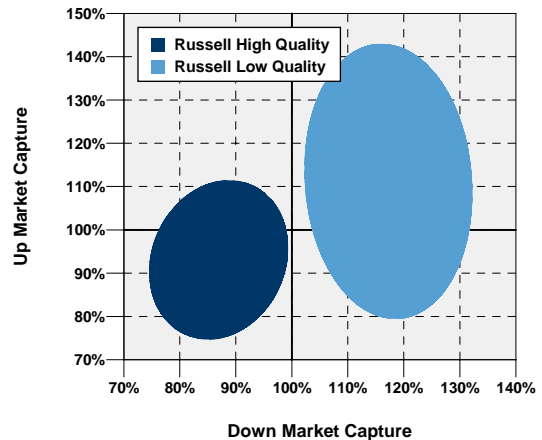


Figure 9. Behavior in Up & Down Markets
Rolling 36-Months for 30 Yrs Ending 12/31/09



Our research indicates that high quality investing is a superior strategy on both an absolute return and risk-adjusted basis relative to size and style-based investing. Figure 8 demonstrates that the Russell High Quality Index appears to be the “optimal” or most efficient index. Over the last three decades, high quality stocks have offered the highest return per unit of risk taken. Notice that over the same time period the Russell Low Quality Index has generated the lowest absolute return and the worst risk-adjusted results of all our indexes. The dispersion between our pair of quality indexes confirms that grouping stocks by earnings variability is closely related to risk and return.

Risk can also be defined as the probability of incurring a significant loss of capital. Down market capture is a common measure used to test the degree of a portfolio’s participation in declining market environments. While down market capture measures the percentage of the index return captured in a “down” market, up market capture measures the percentage of

the index return captured in an “up” market. In this instance, up and down markets are defined as periods when the Russell 3000 Index experienced either a positive or negative monthly return.

Figure 9 plots our high and low quality indexes by their behavior in both rising and declining periods. Each portfolio’s rolling 36-month up and down market capture ratio has been calculated and plotted in the form of an ellipse which encapsulates 80% of the time periods. Notice that the portfolio of high quality stocks preserves the most amount of capital, while the portfolio of low quality stocks fully participates in the market’s decline. For example, over the last 30 years the Russell High Quality Index has participated in roughly 75 – 100% of the market’s decline, while the Russell Low Quality Index has participated in approximately 100 – 130%. This preservation of capital combined with the power of compounding is the basis for high quality’s superior risk-adjusted results.

Does a “Quality Bias” Exist in Institutional Equity Portfolios?

While the size of the investment fund and allocation to US equity dictates the number of managers hired, most institutional investors diversify their equity portfolios by market capitalization and investment style. When this traditional structure is employed, the expectation is that the aggregate portfolio will maintain a neutral exposure to the key risk factors that comprise the broad market index. However, due to manager biases toward high or low quality, a neutral exposure to quality is rarely achieved. The performance of the aggregate portfolio is often influenced by the presence of a strong “quality bias.” In many instances, this quality bias is an unintended consequence resulting from the combination of the investment managers employed, and may pose a serious risk to investors with a short time horizon or low tolerance for underperformance.

To illustrate the market-weight of high and low quality stocks with large market capitalizations, Figure 10 examines the quality composition of a passive set of large cap indexes. Based upon the quality composition of the Russell 1000 Index, approximately 64% of the market value of a large cap portfolio would need to be allocated to stocks ranked “B+ or Better” to remain quality-neutral. Also notice that the quality exposure of the two style indexes are nearly identical to the broad market. This implies that an investor’s passive exposure to large cap value and growth stocks does not materially influence the quality composition of an aggregate portfolio. As shown in Figure 11, the mix between high and low quality stocks within the Russell 1000 Index has remained relatively steady over the past two decades.

Figure 10. Quality Composition of Large Cap Indices As a % of Market Capitalization (December 31, 2009)

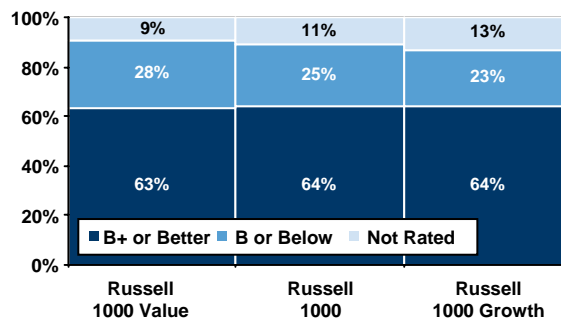
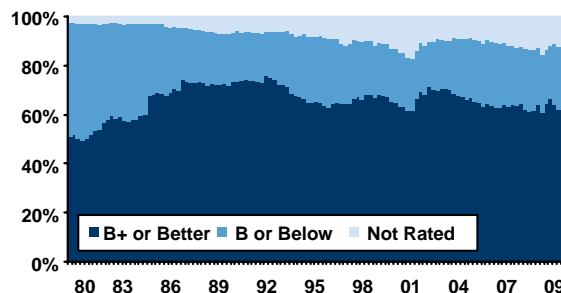


Figure 11. Quality Composition of Russell 1000 As a % of Market Capitalization (1980 – 2009)



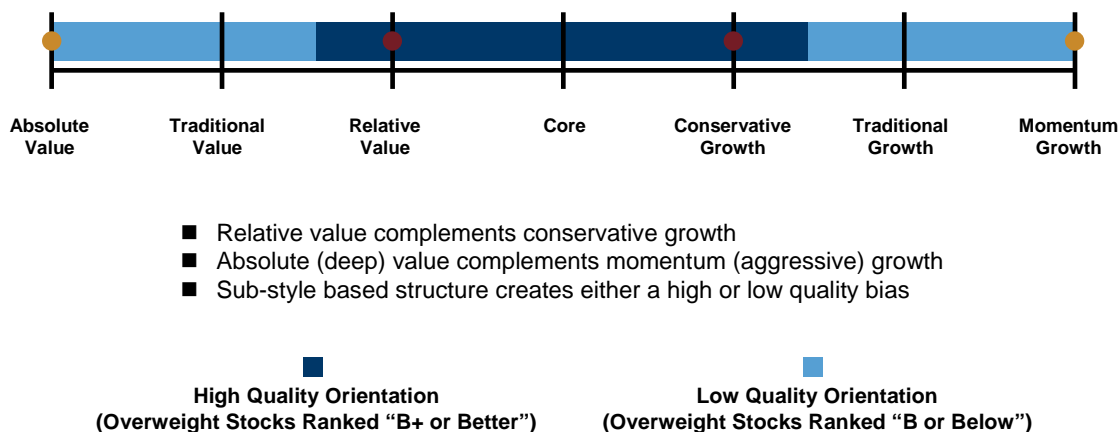
Significant differences in performance between managers within the same style occurred as a result of the technology bubble and ensuing bear market of 2000 – 2002. As a result, investment strategies are now often classified by sub-style. Within the growth style, the universe is comprised of conservative, traditional and momentum growth strategies, while the value style spans relative, traditional and absolute value sub-categories. Although it’s difficult, if not impossible, to find an investment strategy that claims to emphasize “low quality” stocks, investors should be cognizant that high and low quality biases do exist across these six sub-styles of active management.

For many years, it has been our observation that, on average, relative value and conservative growth managers tend to own a higher percentage of “B+ or Better” stocks, while absolute value and momentum growth managers tend to own a higher percentage of “B or Below” and “Not Rated” stocks. Intuitively, this seems reasonable given the vast differences in the risk tolerance of each investment manager. The manager’s risk appetite can be determined by examining the trends in the financial characteristics of the companies held in the portfolio. For example, relative value and conservative growth managers tend to be more risk averse, and invest in companies with long histories of consistency and stability in their fundamentals. Absolute value and momentum growth managers tend to be more aggressive, and purchase companies with more erratic or highly cyclical fundamentals as well as shorter track records as public companies.

Figure 12 demonstrates how the combination of sub-styles may result in an unintended and unrecognized quality bias. Concern arises when the size of the total fund lacks the scale to justify hiring multiple managers within the same style. Often, many small to medium size funds hire a relative value strategy as a complement to a conservative growth strategy or an absolute value manager as a complement to a momentum growth manager. The overall impact on the aggregate portfolio is apparent: **a high or low quality bias will emerge and performance will ebb and flow with the quality cycle.** When the performance of the aggregate portfolio is influenced by an unrecognized quality bias, the fund exposes itself to a potential whipsaw. A high (low) quality oriented manager will be replaced by a low (high) quality oriented manager just when the quality cycle is about to change. This behavior suggests that investors may have failed to adequately measure the risk exposure of their aggregate portfolio and may not understand the three dimensions of portfolio attribution.

Similar to a style or market capitalization cycle, the quality cycle often requires a long time horizon. But, given the favorable risk and return characteristics of high quality stocks, it stands to reason that a strategic allocation to “high quality” could enhance an equity portfolio’s risk-adjusted results. With several indicators pointing to a potential leadership change in favor of high quality, investors may be well served to examine the quality composition of their aggregate portfolio to ensure that they maintain an appropriate level of diversification to high quality ranking stocks.

Figure 12. The Sub-Style Approach to US Equity Manager Structure



About Atlanta Capital

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Disclosures

Sources: Wilshire Atlas, Baseline, Atlanta Capital. Standard & Poor's Quality Rankings are utilized to capture the long-term growth and stability of a company's earnings and dividends in a single measure. The High and Low Quality indexes are provided to compare the aggregate of all companies with above average S&P Quality Rankings (B+ or Better) to those with below average S&P Quality Rankings (B or Below and Not Rated). Rates of return are calculated using a market capitalization weighted-methodology and do not include transaction costs, management fees or other expenses incurred by managed accounts. Performance during certain periods reflects strong stock market performance that is not typical and may not be repeated. Indexes are unmanaged and it is not possible to directly invest in an index. The material is based upon information that Atlanta Capital considers to be reliable, but Atlanta Capital does not warrant its completeness, accuracy or adequacy, and it should not be relied upon as such. This information is provided for information purposes only and is not intended to be and should not be considered investment advice. The opinions expressed herein may change at any time without prior notice, and there is no guarantee that any forecasts or opinions expressed in this material will be realized. This information is for the use of investment professionals only. Reproduction or redistribution of the material in any form without express permission from Atlanta Capital is prohibited.

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